Internal Revenue Service
memorandum

CC:INTL-0532-89
Br3:RLChewning

date:

to: Paul A. Saigh C:DET:AP:PAS
Appeals Officer, Detroit, Michigan

from: Senior Technical Reviewer CC:INTL:Br3

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subject: Informal Technical Advice Request--[redacted] and DISC marginal costing grouping rules at § 1.994-2 (c)(3)(ii)

This informal technical advice request is in response to your letter of July 13, 1989, to Richard Chewning of the Office of Associate Chief Counsel (International) with regard to the DISC marginal costing grouping rules at § 1.994-2 (c)(3)(ii). The issue presented is whether that regulation provision authorizes [redacted] ("[redacted]"), for purposes of computing the commission it paid its DISC, [redacted] ("[redacted]"), for the years ending [redacted], and [redacted], to overlap product line groupings.

Section 1.994-2(c)(3)(ii) provides that for purposes of determining the overall profit percentage ("OPP"), the generally applicable limitation under marginal costing, any product or product line grouping permissable under § 1.994-1(c)(7) may be used as long as the grouping chosen is at least as broad as the grouping used by the taxpayer to compute full costing combined taxable income. Section 1.994-1(c)(7) sets forth the grouping rules that may be used for purposes of computing full costing combined taxable income. Under that regulation section, a grouping will be accepted if it conforms to either a recognized industry or trade usage standard or the SIC classification standard.

[redacted] computed the commissions to be paid to [redacted] on the basis of groups consisting of products or product lines determined under industry or trade usage. [redacted]'s returns reflected [redacted] different product lines groupings. The product line groupings came from [redacted] Business Planning Units (BPU's) that were further sub-grouped by products within that BPU group and also by entity. The five BPU groups were as follows:

[redacted] - [redacted]

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With regard to a number of the product lines, [redacted] and [redacted] used marginal costing to compute the combined taxable income. In some instances, [redacted] and [redacted] computed the OPP by combining or overlapping product lines. If the OPP was small on one product line it would be combined with another product line that had a high OPP in order to increase the OPP for the product line with the low OPP. The product line with a high OPP was used by the taxpayer in several different groupings. The marginal costing OPP limitation for the product line with the highest OPP would be computed separately. The benefit to [redacted] from combining of product lines may be illustrated as follows:

The actual OPP for each of [redacted]'s BPUs is as follows:

No.	Sales (a)	Profit (b)	OPP (a/b)
[redacted]	$[redacted]	$[redacted]	[redacted]%
	$[redacted]	$[redacted]	[redacted]%
	$[redacted]	$[redacted]	[redacted]%
	$[redacted]	$[redacted]	[redacted]%
[redacted]	N/A	N/A	N/A

However, by combining the product lines and by using the most profitable product line (#[redacted]) in more than one grouping, [redacted] increased the OPP for product lines [redacted], [redacted] and [redacted] as follows:

NO.	BPU's Combined	Combined Sales (a)	Combined Profit (b)	Revised OPP (a/b)
[redacted]	[redacted]-[redacted]-[redacted]	$[redacted]	$[redacted]	[redacted]%
	[redacted]-[redacted]-[redacted]	$[redacted]	$[redacted]	[redacted]%
	[redacted]-[redacted]-[redacted]-[redacted]	$[redacted]	$[redacted]	[redacted]%
	None	$[redacted]	$[redacted]	[redacted]%
[redacted]	N/A	N/A	N/A	N/A

The initial adjustment proposed by the international examiner was to disallow the overlapping of product lines so that [redacted] would have to use the OPP as determined on each separate product line. This decreased the combined taxable income which, in turn, reduced the inter-company commissions from [redacted] to [redacted]. However, [redacted] countered this proposed adjustment with a recomputation of the commissions payable to [redacted] based upon [redacted], rather than the original [redacted], product line groupings. In addition, for purposes of computing the

OPP for certain of those [redacted] product lines, [redacted] again overlapped product line groupings. Although the international examiner accepted the [redacted] product lines as being based on industry usage, he again rejected the overlapping of product lines.

In our opinion, § 1.994-2(c)(3)(ii), for purposes of computing OPP, does not preclude the use of a product or product line in more than one grouping so long as any of the new product line groupings would be permissable groupings under the general grouping rules of § 1.994-1(c)(7). For example, with regard to [redacted]'s original computations, BPU [redacted] may be grouped with BPU [redacted] for purposes of determining the OPP for BPU [redacted] even though the OPP is computed separately for BPU [redacted] so long as the combined grouping BPUs [redacted]-[redacted] would be a permissable grouping under the general grouping rules. In our opinion, since the separate groupings BPU [redacted] and BPU [redacted] were each based on industry usage, it is unlikely that the facts will support a conclusion that the combined grouping of BPUs [redacted]-[redacted] is also based on industry usage. In addition, it appears that the combined grouping of GPUs [redacted]-[redacted] would not be a permissable SIC grouping. The same analysis would apply to the combined groupings BPUs [redacted]-[redacted]-[redacted] and BPUs [redacted]-[redacted]-[redacted]-[redacted] and to the combined groupings of the alternative [redacted] product lines. Determinations of whether the broader groupings used by [redacted] are permissable groupings under § 1.994-1(c)(7) are factual determinations that must be established by [redacted].

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